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CITATIONS

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Statutes:

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 351

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WALTER F. TELLIER AND EVELYN H. TELLIER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 4) is not officially reported. The opinion of the court of appeals (R. 10) is reported at 342 F. 2d 690.

JURISDICTION

The judgment of the court of appeals was entered on February 16, 1965 (R. 20). By order of Mr. Justice Harlan, the Commissioner's time for filing a petition for writ of certiorari was extended to July 16, 1965 (R. 22). The petition was filed on July 15, 1965, and certiorari was granted on October 11, 1965

(R. 23). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether legal expenses incurred by respondent in the unsuccessful defense of a federal criminal prosecution for violations of the fraud section of the Securities Act and the mail fraud statute qualify for deduction from taxable income under § 162(a) of the Internal Revenue Code of 1954 as "ordinary and necessary expenses * * * in carrying on any trade or business."

STATUTES INVOLVED

Internal Revenue Code of 1954:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.
> (26 U.S.C. 162.)
>
> * * * * *
>
> SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.
>
> Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.
> (26 U.S.C. 262.)

STATEMENT

Respondent[1] was engaged in the business of underwriting the public sale of stock offerings and purchasing securities for resale to customers. He was tried

[1] Evelyn H. Tellier is a party because she and her husband filed a joint return for the taxable year 1956.

and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933 (48 Stat. 84, as amended, 15 U.S.C. 77(q)(a)), the mail fraud statute (18 U.S.C. 1341), and conspiracy to violate these provisions (18 U.S.C. 371).[2] He was sentenced to four and one-half years imprisonment on each count, to run concurrently, and to a fine of $18,000. In connection with the unsuccessful defense of this criminal prosecution, respondent, in 1956, incurred and paid $22,964.20 legal expenses. He claimed a deduction for that amount as a business expense on his 1956 income tax return (R. 5–6).

The Commissioner disallowed this deduction and his determination was sustained by the Tax Court (R. 7–9). The court of appeals, sitting *en banc*, unanimously reversed (R. 11–19).[3]

INTRODUCTION AND SUMMARY OF ARGUMENT

The decision below marks an abrupt departure from the accepted view that legal expenses incurred in the unsuccessful defense of a criminal prosecution are not deductible in any circumstances. Until the court of appeals reversed the Tax Court in the instant case, the courts, for some 40 years, had uniformly held that such expenses do not qualify for deduction as "ordinary and necessary expenses * * * in carry-

[2] The conviction was affirmed an appeal. *United States* v. *Tellier*, 255 F. 2d 441 (C.A. 2), certiorari denied, 358 U.S. 821.

[3] Taxpayer's petition for a writ of certiorari with respect to a second unrelated issue decided in favor of the Commissioner (*Tellier* v. *Commissioner*, No. 139, October Term, 1965) was denied on October 11, 1965.

ing on any trade or business." Internal Revenue Code of 1954, § 162. This rule was established by the Board of Tax Appeals at least as early as 1925,[4] and had been endorsed by every court of appeals that had passed upon the question,[5] as well as by the Court of Claims.[6] Indeed, the decision of the Second Circuit in the instant case overrules that court's own long-standing position.[7] This Court recognized the unanimous holdings of the lower courts when, in *Commissioner* v. *Heininger*, 320 U.S. 467, 473 n. 8, it stated that, "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a deduction for his attorney's fee." The courts have long agreed that "Such unanimity of views in support of a position representing a reasonable construction of an ambiguous statute will

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[4] *Lindheim* v. *Commissioner*, 2 B.T.A. 229. To the same effect, see *Levinstein* v. *Commissioner*, 19 B.T.A. 99; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B.T.A. 641; *Estate of John W. Thompson* v. *Commissioner*, 21 B.T.A. 568, appeal dismissed, 62 F. 2d 1082 (C.A. 8); *Stralla* v. *Commissioner*, 9 T.C. 801; *Joseph* v. *Commissioner*, 26 T.C. 562; *Standard Coat, Apron & Linen Service, Inc.* v. *Commissioner*, 40 T.C. 858.

[5] *Acker* v. *Commissioner*, 258 F. 2d 568 (C.A. 6), affirmed on other grounds, 361 U.S. 87; *Hopkins* v. *Commissioner*, 271 F. 2d 166, 167 (C.A. 6); *Bell* v. *Commissioner*, 320 F. 2d 953 (C.A. 8); *Peckham* v. *Commissioner*, 327 F. 2d 855, 856 n. 4 (C.A. 4), discussing *MacCrowe's Estate* v. *Commissioner*, 240 F. 2d 841 (C.A. 4).

[6] *Port* v. *United States*, 163 F. Supp. 645 (Ct. Cl.); *Tracy* v. *United States*, 284 F. 2d 379 (Ct. Cl.).

[7] *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C.A. 2); *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. 2d 878 (C.A. 2).

not lightly be put aside." *United States* v. *Davis*, 370 U.S. 65, 71. Moreover, the "ordinary and necessary" business expense provision has been reenacted without substantial change in every Revenue Act since it first appeared in 1918,[8] and Congress presumably has been aware of the construction consistently placed upon it by the Commissioner and the courts.[9]

While the government, over the years, has urged several grounds supporting disallowance of a deduction for attorney's fees incurred in unsuccessfully defending a criminal prosecution, principal reliance has been placed on the argument that overriding public policy requires the disallowance of such expenses. Point I(A) of this brief sets forth the Commissioner's argument on the application of the public policy doctrine to respondent's attorney's fees. The Acting Solicitor General has doubts, however, that this doctrine should be applied to payments other than those which are themselves illegal or which are intended as punishment for illegal acts. We therefore present the countervailing arguments for the Court's consideration in Point I(B).

The government has also argued in cases similar to this one that, considerations of public policy aside, expenses such as respondent's should be non-deductible

[8] Section 214(a), Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066. See, *infra*, p. 25, for the pre-1918 history of the business deduction provision.

[9] See, *e.g.*, S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 16, 124–125, accompanying Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606, Section 5, which added Section 162(c) of the 1954 Code.

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because they fail to qualify as "ordinary and necessary" in the generally accepted sense and are primarily personal in nature. The Commissioner does not press these other grounds for reversal. However, since these issues are within the framework of the present case, bear a close relation to the public policy argument, have been relied upon by lower courts as additional reasons for disallowing attorney's fees incurred in unsuccessfully defending a criminal prosecution, and derive, at least in part, from statements by this Court, we have set forth in Point II of this brief the competing considerations which bear upon their resolution.

ARGUMENT

I

THE COMMISSIONER URGES THAT OVERRIDING PUBLIC POLICY REQUIRES THE DISALLOWANCE OF LEGAL EXPENSES INCURRED IN THE UNSUCCESSFUL DEFENSE OF A CRIMINAL PROSECUTION

A. THE COMMISSIONER'S POSITION

The Internal Revenue Code nowhere directs that considerations of public policy shall be taken into account in determining the deductibility of expenses which otherwise qualify. Viewed as an original matter, therefore, it might be argued that since the Code is not drawn with an eye to considerations of policy and morality, the courts should leave those matters to regulation by other means. The lower courts, however, have long since decided that in some contexts they should give heed to weighty considerations of policy. And this Court has made clear in recent years

that in at least some circumstances "business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible" (*Lilly* v. *Commissioner,* 343 U.S. 90, 96) because their allowance would frustrate sharply defined public policy. *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U.S. 30; *Hoover Motor Express* v. *United States,* 356 U.S. 38 (both disallowing deductions for fines paid to the State). "We will not presume that the Congress, in allowing deductions for income tax purposes, intended to encourage a business enterprise to violate the declared policy of a State [or the federal government]." *Tank Truck, supra,* p. 35.

On the other hand, the Court appears to have rejected a broad rule that would disallow any expenditure that flows directly from or is caused by an illegal act. In light of the high prevailing tax rates such a rule would certainly discourage the commission of the proscribed acts. However, the Court has recognized that a more flexible rule was needed in order "to accommodate both the congressional intent to tax only net income, and the presumption against Congressional intent to encourage violation of declared public policy." *Ibid.* Thus, in *Commissioner* v. *Heininger,* 320 U.S. 467, the Court allowed a deduction for attorney's fees incurred by the taxpayer in unsuccessfully defending against an administrative fraud order issued by the postal authorities, although it recognized that the taxpayer's acts might well constitute a federal criminal offense (p. 474). And in

Commissioner v. *Sullivan*, 356 U.S. 27, the Court held that the "normal" expenses of an illegal business, such as rent and salaries, which are tainted only because the entire business is illegal, may be deducted even if their payment is specifically proscribed by State law, since the Court will not presume that Congress intended such a business to be "taxable on the basis of its gross receipts, while other business would be taxable on the basis of net income" (p. 29).

The Court has thus adopted an approach designed to accommodate conflicting considerations—denying a deduction only for those expenses the allowance of which would most seriously frustrate public policy. "The test of non-deductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." A deduction will be allowed, however, if the "expenditure bears [only] a remote relation to the illegal act." *Tank Truck*, p. 35. In deciding the present case, the Court must accordingly determine on which side of the line respondent's attorney's fees fall.

In the instant case the Second Circuit adopted a novel approach to the public policy issue—one which is demonstrably at variance with the teaching of this Court. This Court has made it clear that in determining the deductibility of expenses incurred in defending a lawsuit, the expenses must be viewed in light of "the origin and character of the claim" (*United States* v. *Gilmore*, 372 U.S. 39, 49) and that "the kind of transaction out of which the obligation arose" determines its character for tax purposes

(*Deputy* v. *duPont*, 308 U.S. 488, 496). See also, *e.g.*, *Kornhauser* v. *United States*, 276 U.S. 145; *United States* v. *Patrick*, 372 U.S. 53; *Lykes* v. *United States*, 343 U.S. 118. Since respondent's legal fees are the direct and predictable result of his violations of three federal criminal statutes, their deductibility must be considered in light of the public policy embodied in those statutes—the fraud section of the Securities Act of 1933, the mail fraud statute, and the federal conspiracy statute.

The Second Circuit, however, failed to consider the policies expressed by these statutes. Instead, it addressed itself to the question whether "There has been [any] 'governmental declaration' of any 'sharply defined' national or state policy [of] discouraging the hiring of counsel and the incurring of other legal expense in defense against a criminal charge" (R. 15). After reaching the inevitable result that there was certainly no such policy, that court ended its search before it had actually begun, concluding that there was "no sharply defined public policy against the allowance of" respondent's expenses (R. 17).

The Commissioner of course agrees with the Second Circuit's conclusion that respondent had a constitutional right to be represented by counsel in connection with his criminal trial. That court's error, however, was to assimilate the *right to retain counsel* and the *right to deduct counsel fees* for purposes of computing federal income tax liability. Denial of the deduction does not impair the defendant's freedom to select any attorney or to pay him any stipulated fee.

Rather, it might be said that allowance of the deduction would in some measure subsidize the defendant's cost of his legal defense.

It is axiomatic that "only as there is clear provision therefor can any particular deduction be allowed." *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440. See also *Deputy* v. *du Pont,* 308 U.S. 488, 493. An expense which does not come within one of the authorizing provisions is not deductible simply because it is incurred in connection with the exercise of a constitutional right. Many personal expenses flow from the exercise of constitutionally guaranteed rights, but for purposes of computing income tax liability they are nevertheless clearly non-deductible. As the Tax Court stated, the "fact that an expenditure is in connection with a constitutionally guaranteed right does not require the conclusions that the amount so expended is deductible as an ordinary and necessary business expense" (R. 7).

In *Cammarano* v. *United States,* 358 U.S. 498, the taxpayer deducted as business expenses sums paid for publicity designed to persuade voters to defeat proposed State initiative legislation which would have the effect of destroying his business. In holding that such expenses—although made in the course of exercising a constitutionally guaranteed right—were not deductible under § 162, the Court stated (p. 513):

> Petitioners are not being denied a tax deduction because they engage in constitutionally protected activities, but are simply being required to pay for those activities entirely out of their own pockets, as everyone else en-

> gaging in similar activities is required to do under the provisions of the Internal Revenue Code. * * *

Similarly, the fact that retaining counsel to defend against a criminal charge is a "constitutionally protected" right is not dispositive of the right to deduct such fees. Surely the Second Circuit would agree that the expenses of defending a criminal case arising out of non-profit-seeking activities are non-deductible. The crucial question which remains is whether the expense qualifies for deduction under the Code. The "nondiscriminatory denial of a deduction" for such fees would merely put "everyone in the community * * * on the same footing as regards [the payment of the cost of unsuccessfully defending a criminal prosecution] * * * so far as the Treasury of the United States is concerned" (*Cammarano* v. *United States, supra,* p. 513). Given the progressive nature of the tax rates and the variety of distinctions in defining the tax base and deductions of taxpayers, use of the income tax laws as a vehicle for promoting adequate representation in criminal proceedings would be a singularly inappropriate choice.

This Court's opinion in *Commissioner* v. *Heininger,* 320 U.S. 467, demonstrates the error in the Second Circuit's reasoning. In *Heininger* the taxpayer sought to deduct attorneys fees incurred in unsuccessfully attacking a post office fraud order which threatened his business by denying him use of the mails. The Court held that allowance of the deduction would not frustrate sharply defined national or State policies

since the postal statute in question was designed solely "to protect the public" and not "to impose personal punishment on violators" (p. 474). At the same time, the Court also observed that "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a tax deduction for his attorney's fee" (p. 473, fn. 8). Respondent's expenses in the instant case were incurred in unsuccessfully defending a prosecution under three federal statutes designed "to impose personal punishment on violators." Respondent's expenses, therefore, falls squarely within the class that this Court's *Heininger* opinion contemplated would be non-deductible.

Respondent's attorney's fees in connection with his criminal trial are intimately and inextricably connected with the entire legislative and judicial machinery for preventing, combating, and punishing crime. They were directly occasioned by the illegal acts and incurred in the very proceeding in which guilt was determined and punishment imposed. Such expenses are no more remote from the illegal conduct than the fine levied upon conviction, which this Court has already held non-deductible in *Tank Truck Rentals*. In sum, it would stretch this Court's language to classify respondent's criminal trial expenses as bearing merely "a remote relation to an illegal act." *Commissioner* v. *Heininger, supra,* p. 474; *Commissioner* v. *Sullivan,* 356 U.S. at 29. The "severity and immediacy of the frustration resulting from allowance of [respondent's] deduction," *Tank Truck*

Rentals, Inc. v. *Commissioner, supra,* p. 35, is established, first, by the level at which the public policy is expressed, here a penal law;[10] second, by the closeness of the relation between the legal expenses and the criminal conduct; and, third, by the relatively remote and insignificant frustration to the countervailing policy to tax net rather than gross income.[11] As the Court said in *Textile Mills Corp.* v. *Commissioner,* 314 U.S. 327, 339, the Treasury is warranted in "drawing a line between legitimate business expenses and those arising from that family of contracts [or transactions] to which the law has given no sanction." To be sure, the Court in *Textile Mills* and *Cammarano* relied upon a long-standing Treasury Regulation which forbade the deduction of sums expended for the promotion or defeat of legislation. Although there is no Treasury Regulation which proscribes the deduction of legal expenses incurred in the unsuccessful defense of a criminal prosecution, there is a long-standing judicial doctrine to that effect. See cases cited, *supra,* p. 4; *Commissioner* v. *Heininger, supra,* p. 473 n. 8.

The ultimate question, of course, is one of Congressional intent. As shown above, there has been a consistent administrative position over the course of

[10] Contrast *Commissioner* v. *Heininger, supra,* pp. 474–475, and *Lilly* v. *Commissioner, supra.*

[11] Contrast *Commissioner* v. *Sullivan,* 356 U.S. 27. Here the Commissioner does not seek to disallow all of Tellier's expenses related to his illegal conduct, however remotely, such as rent and wages. Disallowance of the single item of legal fees can hardly be said to "come close to making this type of business taxable on the basis of its gross receipts." *Id.* at 29.

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many years and a long line of decisions sustaining the Treasury's view. Since Congress, during this same period, repeatedly reenacted § 162 and since it was presumably aware of the administrative and judicial decision,[11a] there is strong basis for concluding that the Commissioner's position correctly reflects the legislative purpose and that respondent's expenses are not deductible.

B. THE COUNTERVAILING CONSIDERATIONS

The Acting Solicitor General, while agreeing that the recurring legal question here presented should be resolved, has doubts as to the correctness of the Commissioner's position in this case. In all events, it may prove helpful to set forth the opposing arguments and to suggest an alternative line of approach to this and related cases.

As stated above, this Court has chosen neither to ignore considerations of public policy in determining the deductibility of expenses nor to disallow deductions for all expenses flowing out of an illegal act. While the issue is not free from doubt, we believe that the logic of the Court's rationale in choosing the middle rather than either of the extreme positions regarding the effect of public policy on deductions militates in favor of allowing a deduction for respondent's fees if they otherwise satisfy the requirements of § 162. "[T]he test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." Thus the public policy doctrine will be invoked only when

[11a] See fn. 9, *supra*, p. 5.

allowance of the deduction would "encourage a business enterprise to violate * * * declared policy * * * by increasing the odds in favor of noncompliance." *Tank Truck, supra,* p. 35. Once it has been decided that Congress did not intend the sharp departure from a tax on net income that would result from disallowing all expenses incurred as a result of an illegal act, we believe that disallowance should be limited to those expenditures which are themselves illegal,[12] such as prohibited bribes and kickbacks, and those exactions which are intended as punishment for illegal acts.

The public policy doctrine is, we submit, most clearly applicable to payments intended by the sovereign to punish an offender, whether paid to the government or to private parties. The purpose of a fine or penalty is both to punish the violator and to deter him from again violating the law. Allowing a deduction would reduce the intended "sting" (*Tank Truck,* p. 36) and mitigate the fine's deterrent effect.[13]

It is perhaps not quite as clear that payments which are themselves illegal should be disallowed as deductions. If a taxpayer paid a $10,000 bribe in order to sell merchandise for $50,000 that had cost him $37,500, his actual before-tax profit from the transaction would be $2,500 ($50,000 less $37,500 and $10,000). If, however, the bribe is disallowed for

[12] Other than the "normal" expenses of an illegal business. See *Commissioner* v. *Sullivan,* 356 U.S. 27, 29, and *supra,* p. 8.

[13] This would be untrue only if the court had wide discretion in assessing the amount of fines and did so with due regard for the defendant's tax bracket.

tax purposes and the taxpayer is in the 50% tax bracket, he would be required to pay an income tax of $6,250 (50% of $12,500), *i.e.*, more than double his actual gain from the transaction. Thus the federal tax laws would impose a penalty in proportion to the amount of the illegal expenditure and the taxpayer's income tax bracket, rather than the seriousness of the offense committed. Nevertheless, we believe, on balance, that no deduction should be allowed for illegal expenditures.[14] While it is not the purpose of the tax laws to impose additional penalties for illegal acts, permitting a deduction for those expenditures which are themselves prohibited by federal or State criminal law would cause the federal treasury in effect to subsidize the illegal payment. A taxpayer in the 50% bracket who paid a $10,000 bribe would have his income tax liability reduced by $5,000, and the federal government would thus in effect be subsidizing the illegal payment. Not only might a deduction increase the violator's chances of profiting from illegal conduct; more pointedly, it is difficult to believe that Congress in enacting the Code could have intended the federal treasury in effect to provide a part of the money for an illegal payment.[15] If the choice must be made between adding a penalty to conduct which is

[14] See fn. 12, *supra*, p. 15.

[15] See Code § 162(c), disallowing a deduction for any payment to an official of a foreign government where the payment would have been illegal under the laws of the United States, if they had been applicable. In enacting this provision in 1958 Congress apparently assumed that no deductions would be allowed for a payment actually made in the United States which was itself illegal. See S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 16, 124–125.

already criminal in nature and subsidizing illegal payments, we believe the choice to be clear.[16]

While it would certainly deter illegal conduct if all expenses incurred directly or indirectly as a result of a criminal act were non-deductible, we do not think that Congress can be presumed, absent a clearer demonstration of legislative purpose, to have intended such a sharp departure from the basic concept of a tax on net income measured by business profits. Although attorney's fees and expenses incurred during the unsuccessful defense of a criminal prosecution flow from the illegal act and are as much a consequence of it as the non-deductible penalty assessed after conviction, allowing a deduction for such expenditures would no more encourage criminal conduct than allowing deductions for compensatory civil damages and attendant legal expenses, which are presumably deductible.[17] Indeed, we have the gravest

[16] The Court noted in *Tank Truck* that "the frustration of state [or federal] policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute" (p. 35).

[17] As the Chief Justice stated in *James* v. *United States*, 366 U.S. 213, 219–220 (announcing the judgment of the Court):

> When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as "gross income" in the year received. * * * We do not believe that Congress intended to treat a law-breaking taxpayer differently. *Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that, "If, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a re-deduction in the embezzler's income."* [Emphasis added.]

The Internal Revenue Service has itself approved deductions for civil remedial damages and attendant attorney's fees, al-

doubt that either type of deduction bears upon the decision of businessmen to engage in violations of law.

The Court's opinion in *Commissioner* v. *Heininger*, 320 U.S. 467, suggests, however, that a distinction might be drawn between the deductibility of attorney's fees in civil and criminal suits. In that case, the Court allowed a deduction for attorney's fees incurred in resisting a postal fraud order, although the taxpayer's conduct may well have been criminal. In so concluding the Court stated that the purpose of the postal statute in question was "to protect the public," not, like a criminal statute, "to impose personal punishment on violators" (p. 474). While the prosecution against the present respondent was clearly intended to punish him, Congress explicitly set forth by statute the possible penalties that could be imposed, and the court, in its discretion, imposed an $18,000 fine and 4½ years imprisonment. Neither Congress nor the courts regarded the attorney's fees which respondent incurred in defending against the charges as a further penalty or punishment for his wrong. The retention of counsel is a basic constitu-

though the expenses were caused by a criminal act. In Rev. Rul. 64–224, 1964–2 Cum. Bull. 52, the Service ruled that taxpayers who had been convicted of criminal antitrust violations could deduct amounts paid in satisfaction of treble damage claims and attendant attorney's fees. The Service's ground was that treble damage claims were "remedial in nature" rather than intended "to punish the wrongdoer." Regardless of whether the Service correctly concluded that antitrust treble damages were "remedial" rather than punitive, the principle would undoubtedly apply to a compensatory damage suit by the victim of a fraud or embezzlement.

tional right, not an additional penalty deriving from the institution of a criminal prosecution.

If a deduction is permitted for respondent's attorney's fees, his tax liability will be reduced, at least to the extent of the tax on the income which he used to pay the fees. In this respect the federal government would not be treating respondent's attorney's fees any better than it treats his other expenses of earning income. One of the Code's basic principles is that ordinarily no tax will be levied on income which is used to pay business expenses, *i.e.*, that only net income remaining after the payment of expenses will be taxed. This reflects the Code's underlying concept that the amount of tax due should be based on ability to pay, which in turn depends on the amount of income a taxpayer has retained after paying the expenses necessary to earn that income.[17a] A deduction will be disallowed for a business expense which otherwise satisfies the requirement of § 162 only when there is a clearly overriding policy. Such is the case, under decisions of this Court, with fines and penalties and payments which are themselves illegal. However, we acknowledge serious doubt that such an overriding policy in favor of disallowance exists with respect to attorney's fees incurred in unsuccessfully defending a criminal proceeding directed to offenses which are business-related.

[17a] See 50 Cong. Rec. 3849, quoted in part, *infra*, p. 24.

II

THE GOVERNMENT ACQUIESCES IN THE VIEW THAT, CONSIDERATIONS OF PUBLIC POLICY APART, RESPONDENT'S FEES MAY BE VIEWED AS SATISFYING THE REQUIREMENTS THAT THEY BE "ORDINARY AND NECESSARY" AND NOT PRIMARILY PERSONAL IN NATURE

A prerequisite to deductibility under the Code is that respondent's expenses were primarily business-related, rather than personal, and that they were "ordinary and necessary" in the sense that those words are used in the Code. The court below concluded that these requirements were met. The Commissioner does not seriously challenge this aspect of the Second Circuit's decision. Ordinarily, therefore, it would seem unnecessary to go further. However, there are numerous decisions of the courts which have denied deductibility and have rested, at least in part, on the view that a payment of the kind here in issue does not meet the above-stated requirements. Some statements of this Court also appear to suggest this. For these reasons, we deem it appropriate to set forth the arguments, pro and con, bearing on the "ordinary and necessary" and "personal" issues—issues which are somewhat related to the public policy question discussed above and are in all events within the framework of this litigation.

A. PERSONAL VERSUS BUSINESS EXPENSES

Expenditures that are motivated primarily by personal rather than business considerations must un-

questionably be disallowed. 1954 Code § 262.[18] However, whether the expenses of resisting a lawsuit are to be treated as essentially personal or are sufficiently business-related to be deductible depends not upon the suit's "potential consequences upon the fortunes [or liberty] of the taxpayer," which are certainly "personal" here, but rather upon "the origin and character of the claim," *i.e.*, "whether or not the claim *arises in connection with* the taxpayer's [business or] profit-seeking activities." *United States* v. *Gilmore*, 372 U.S. 39, 48–49 (emphasis in original); see also, *e.g.*, *United States* v. *Patrick*, 372 U.S. 53; *Lykes* v. *United States*, 343 U.S. 118; *Deputy* v. *du Pont*, 308 U.S. 488, 494, 496.

Thus, whether a taxpayer's expenses of defending a personal injury suit will be treated as personal or business in nature depends solely on whether the taxpayer was engaged in personal or business endeavors at the time of the accident out of which the suit arose. If the taxpayer was a sole proprietor driving his delivery truck on a business errand at the time of the accident his expenses of defending a tort suit have "a business origin" (*United States* v. *Gilmore*, *supra*, p. 45); and if all of the other requisites for deductibility are satisfied the legal fees will be deductible under § 162. If, on the other hand, the taxpayer, at the time of the accident in question, was driving his automobile on a personal trip, "the

[18] Some of the early administrative determinations disallowed legal expenses incurred in unsuccessfully defending business-origin crimes on the ground that they were personal. See O.D. 952, 4 Cum. Bull. 209 (1921); S.R. 3137, IV–1 Cum. Bull. 170 (1925).

source of the [tort] claim" would be personal (*United States* v. *Patrick, supra,* at 57), and the fees of defending it non-deductible.

While it could be argued that the origin of respondent's legal fees was his willful criminal act—and thus that they have a personal rather than a business origin—we do not think that this is the meaning of the *Gilmore* line of decisions. Rather those cases, as well as the relevant policy considerations, indicate that in determining the origin of litigation expenses the question is whether the activities that gave rise to the suit were intended to produce a profit,[19] on the one hand, or were primarily personal activities on the other. The criminal prosecution here in question was based on false and fraudulent representations which respondent made in an effort to sell securities. Whether respondent is regarded as being engaged in two businesses—the lawful sale of securities and the fraudulent sale of securities—or whether he is viewed as being in only one business—the sale of securities by either lawful or unlawful means—we believe that respondent's business activities were "the source of the claim" (*United States* v. *Patrick, supra,* at 57), and the resulting legal fees arose out of or "in connection with" his business.

[19] If the profit-seeking activities rise to the level of a trade or business, § 162 would be the relevant deduction section; if they do not qualify as a trade or business, it would be § 212. In either event the considerations are essentially the same. See *infra*, p. 25.

Nor is it relevant that the consequences of losing the lawsuit had a direct effect on respondent's personal life, *i.e.*, a jail term of 4½ years, since deductibility turns on "the origin * * * of the claim" rather than "on the *consequences* that might result to a taxpayer * * *" from loss of the suit. *United States* v. *Gilmore, supra,* at 48, 49 (emphasis in original).[20]

B. THE REQUIREMENT OF "ORDINARY AND NECESSARY"

1. Even if a particular expenditure is primarily business rather than personal in nature, it must, in order to be deductible, qualify as an "ordinary and necessary expense * * * [of] carrying on [a] trade or business" (Int. Rev. Code of 1954, § 162(a)). As we view § 162, these words are intended primarily to distinguish between recurring expenses of the taxpayer's business activities, on the one hand, and capital or primarily personal expenditures on the other. This Court has always interpreted the word "necessary" in a liberal manner, well designed to carry out the statute's purpose. Rather than giving "necessary" a strict definition such as "essential" or "indispensable" (Webster's New Collegiate Dictionary, p. 561 (1959 ed.)), the Court has regarded any expense

[20] Moreover, to disallow respondent's expenses on the ground that they were personal would result in a sharp difference in tax treatment between legal fees incurred by a taxpayer doing business in an unincorporated form and those of a corporate taxpayer (*e.g.*, in a criminal antitrust suit). Presumably none of the latter's expenses could be disallowed as personal. If, however, the Court concludes that such expenses do not qualify as "ordinary and necessary" or that their allowance would frustrate public policy, individual and corporate taxpayers would be treated alike.

as "necessary" within the meaning of § 162 and its predecessors if it is "appropriate and helpful" in "the development of the petitioner's business." *Welch* v. *Helvering,* 290 U.S. 111, 113; see, also, *e.g., Lilly* v. *Commissioner,* 343 U.S. 90, 93–94; *Commissioner* v. *Heininger,* 320 U.S. 467, 471. However, in defining "ordinary" the Court has at times appeared to require that an expense also be "of common or frequent occurrence in the type of business involved." *Deputy* v. *du Pont,* 308 U.S. 488, 495.

As stated *supra,* pp. 8–9, 21, the deductibility of expenses incurred in defending a lawsuit must be viewed in light of "the kind of transaction out of which the [suit] arose." Since fraud is presumably not common in the securities business, it becomes necessary to determine whether frequency is an essential ingredient of the "ordinary and necessary" concept.

While Congress did not focus on the issue, the legislative history of the Internal Revenue Code suggests that it intended no such prerequisite to deductibility. During the Senate debate in 1913 (the year the income tax was first enacted), Senator Williams, who was in charge of the bill, stated on the floor that it was designed to tax net business income:

> that is to say, what [a man] has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters * * *. [T]he purpose [is to make] * * * a man pay upon his net income, his actual profit during the year. [50 Cong. Rec. 3849.]

The Revenue Act of 1913 allowed a deduction for the "ordinary and necessary" business expenses of a corporation and the "necessary" business expenses of an individual. Revenue Act of 1913, c. 16, 38 Stat. 114, 166, §§ II(G)(b) (corporations) and § II(B) (individuals). Five years later, the word "ordinary" was added to the section covering individuals' deductions. Revenue Act of 1918, c. 18, 40 Stat. 1057, § 214 (a)(1). However it appears that this change was designed merely to make the language of the two sections consistent.[21] H. Rep. No. 767, 65th Cong., 2d Sess., p. 10; 4 Mertens, *Law of Federal Income Taxation*, § 25.01, fn. 2 (1960 Rev.).

In 1942, Congress added a new section to the Code, permitting taxpayers to deduct non-business "ordinary and necessary expenses" incurred in profit-seeking ventures. This Court has recognized that this new section (the predecessor to present § 212) was intended to grant a taxpayer engaged in a profit-seeking activity the same tax treatment as those engaged in a trade or business, with the sole exception "that the income-producing activity [need not] qualify as a trade or business." *United States* v. *Gilmore*, *supra*, at 45; *McDonald* v. *Commissioner*, 323 U.S. 57, 62; *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 373, 374. Accordingly, the legislative history of § 212, expressing Congress' understanding of "ordinary and necessary," is relevant in interpreting the

[21] One possible purpose of "ordinary" is to prevent capital expenditures from coming within § 162.

The two sections regarding business deductions of individuals and corporations were combined in 1928 (Revenue Act of 1928, c. 852, 45 Stat. 791, § 23(a)).

identical words in § 162. The Committee Reports on § 212's predecessor state that the purpose of the section is to allow a deduction "whether or not the expense is in connection with the taxpayer's trade or business, *if it is expended in the pursuit of income* * * *" and are "ordinary and necessary, which rule presupposes that they must be reasonable in amount and *must bear a reasonable and proximate relation to the production or collection of income* * * *." H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 75 (emphasis added). To the same effect, see S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87–88.[22]

We conclude, therefore, that if money "is expended in the pursuit of" a trade or business, it should not be disallowed solely on the ground that it is a novel type of expenditure or constitutes an innovation in the taxpayer's line of business. For example, if none of the competitors in a given line of business had ever before advertised their product because all were more or less fungible (*e.g.*, cranberries or potatoes), expenses incurred by a group of taxpayers who in good faith attempt to further their business by advertising designed to distinguish their product from the rest should not be disallowed. Similarly, the expenses of adopting automation should not be rendered nondeductible merely because the taxpayer was the first

[22] The Committee Report to an earlier draft of what eventually was enacted as § 212's predecessor stated that to be deductible an expense must be "immediately and directly incurred in the collection or production of income." Report of the House Ways and Means Subcommittee, dated January 14, 1938, 75th Cong., 3d Sess., pp. 46–47.

in his industry to adopt the practice.[23] If the Commissioner and the courts were required to disallow expenses solely because they were not common or frequent in the taxpayer's industry, business initiative and innovation would certainly be discouraged.[24] See

[23] Such an interpretation of § 162 would not require this Court to overrule any of its prior decisions. In *Welch* v. *Helvering*, 290 U.S. 111, the Court properly denied the taxpayer a deduction for his expenditures in payment of the debts of a predecessor corporation that had been discharged in bankruptcy. As the Court noted, these expenditures were "in the nature of capital expenditures, an outlay for the development of reputation and good will" (p. 113) and thus not deductible in the year paid in any event. In *Deputy* v. *du Pont*, 308 U.S. 488, the decision in which the language here in question first appeared, the Court properly denied a deduction for expenses incurred by a stockholder in obtaining stock for sale to executives of a company in which he owned 16% of the stock. The Code did not then permit a deduction for expenses incurred in a profit-making venture which did not qualify as a trade or business (*e.g.*, owning stock as an investor). The Court recognized that the stockholder's expenses were non-deductible because not incurred in *his* trade or business (pp. 493–494), and added the language here in question merely as dicta or alternative holding (pp. 494–496). In fact, the concurring Justices expressly disavowed this unnecessary language and relied solely on the taxpayer's lack of a trade or business (p. 499). Nor, of course, would disavowal of any requirement that an expense be common or frequent in the taxpayer's type of business change the result reached in *Lilly* v. *Commissioner*, 343 U.S. 90, where the opticians' payments to prescribing optometrists were held deductible. There, the Court found such payments to be customary in the industry and thus did not have to reach the question whether they would have been deductible if there had been no such established practice.

[24] In fact the Service and the Department of Justice have seldom advanced this argument except with regard to expenses which are immoral or illegal (such as in *Lilly* v. *Commissioner*, 343 U.S. 90, and *United Draperies, Inc.* v. *Commissioner*, 340

Lamont, *Controversial Aspects of Ordinary and Necessary Business Expense,* 42 Taxes 808, 835 (1964).

2. Even if an expense would appear to fit within these definitions of "ordinary and necessary" it must also bear a "direct and proximate" relationship to the taxpayer's business. See *Kornhauser* v. *United States,* 276 U.S. 145, 153; *Trust of Bingham* v. *Commissioner,* 325 U.S. 365, 370, 374. See also H. Rep. No. 2333, 77th Cong., 2d Sess., p. 75, quoted and discussed, *supra,* p. 26. In other words, an expense may have its ultimate origin in a business purpose, yet be deemed too remote to qualify. For example, if an attorney joined a country club to which his more successful brethren at the bar belonged solely because he expected the resulting "shop talk" to increase his legal knowledge and standing, and thus further his business, the tax law ought not to permit a deduction for his dues. Taxation is a practical matter, and to attempt to separate out and attach significance to every element of business advantage accruing from the processes of living—especially living in a world in which business and pleasure are often inextricably woven together—would prove fruitless. Although

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F. 2d 936 (C.A. 7), certiorari denied, October 11, 1965), and the Treasury Regulations promulgated under § 162 do not even mention any requirement that expenditures must be common or frequent in the taxpayer's industry. See Treas. Regs. §§ 1.162-1 through 1.162-19.

Nor do we believe that this Court's definition of "necessary" as "appropriate and helpful" implies that an expenditure which is reasonably intended to further the business' goal of making a profit must survive some court's moral judgment of business propriety.

activities of this kind may be helpful in furthering a taxpayer's business and he may have engaged in them primarily for business rather than personal or social reasons, the relationship between such an activity and the taxpayer's business is too intangible and remote to be described as "proximate" or "direct" or "ordinary."

It might be argued in similar vein that any expenses incurred in connection with a criminal prosecution should be non-deductible (wholly apart from the public policy doctrine considered above) because the criminal prosecution constitutes an intervening event sufficient to destroy the essential nexus between the expenses and the business. That is to say, there is something special about a criminal contest between a taxpayer and his sovereign that makes it peculiarly distinct and remote from its business or profit-seeking origin.[25]

One of the difficulties with this approach is that the expenses of defending a business-origin damage suit are generally deductible. *Kornhauser* v. *United States,* 276 U.S. 145; *Commissioner* v. *Heininger,* 320 U.S. 467; Rev. Rul. 64–224, 1964–2 Cum. Bull. 52. The institution of a civil damage suit is not a sufficient intervening force to make the fees and damages too remote even where the acts which gave rise to the civil suit were also criminal. See *Commissioner* v. *Heininger, supra;* Rev. Rul. 64–224, *supra.* Unde-

[25] Whether this argument, if accepted, would apply only where the taxpayer was convicted, or would apply whenever a criminal prosecution was the cause of the expenses need not now be decided, for in any event, by virtue of his criminal conviction, respondent would be covered.

niably, many public welfare statutes which impose punitive sanctions upon a business enterprise do not require any more proof of intent or culpability than a civil suit.[26] The principal difference between a prosecution of that type and a civil action is the sovereign's decision that, in addition to civil liability, the offender should be punished. Blanket disallowance of all expenses related to a criminal case of this kind might impose an additional penalty on the taxpayer out of all proportion to the seriousness of the offense or the penalty set by the legislature or the convicting court. Accordingly, we doubt that the expenses of defending a criminal prosecution should be considered too remote from the business activities which gave rise to them while the expenses of defending a similar civil suit will be regarded as sufficiently "direct and proximate."

[26] The Court has nevertheless declined in a closely related context to distinguish between wilful and inadvertent crimes. See *Hoover Motor Express* v. *United States*, 356 U.S. 38.

CONCLUSION

If the Court agrees with the Commissioner's long-standing position that attorney's fees incurred in the defense of an unsuccessful prosecution are non-deductible, the judgment below should be reversed. If, however, the Court concludes that the public policy doctrine should not be applied to that situation, the conflict among the circuits should be resolved by an affirmance of the Second Circuit's judgment.

Respectfully submitted.

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*In lieu of the Solicitor General, who has disqualified himself.

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